Supreme Court, U.S.
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No. _____

In the Supreme Court of the United States

MARTIN BROS. CONTAINER & TIMBER PRODUCTS CORP., an Ohio Corporation; MARTIN BROS. CONTAINER & TIMBER PRODUCTS CORP., a Tennessee Corporation,
Petitioners,

v.

RAYMOND J. MARTIN; DOLORES J. MARTIN; CECELIA A. AUSTIN,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

(1) Whether the hypothetical willing buyer-willing seller standard for determining the value of stock in a closely held C-corporation requires full recognition of built-in capital gains under the net asset valuation method.

(2) Whether the treatment of built-in capital gains under the net asset valuation method is a question of law or of fact.

RULE 29.6 STATEMENT

Petitioners have no parent company, and there are no publicly held companies that own any stock of the petitioners.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

RULE 29.6 STATEMENT ii

TABLE OF CONTENTS iii

TABLE OF AUTHORITIES v

PETITION FOR CERTIORARI 1

OPINIONS BELOW 1

JURISDICTION 1

REGULATIONS INVOLVED 1

STATEMENT OF THE CASE 2

A. Built-in Capital Gains and the General Utilities Doctrine 2

B. Factual and Procedural History in the Present Case 4

REASONS FOR GRANTING THE PETITION 7

I. The Circuits are Divided Over the Proper Treatment of Built-in Capital Gains 8

A. *Eisenberg* and Progeny Reject Dollar for Dollar Recognition of Built-in Capital Gains . 8

B. *Dunn* Requires Full Recognition of Built-in Capital Gains as a Matter of Law 11

II. *Dunn* is the Superior Approach and Supported by Appraisal Standards 13

A. The Reasoning of *Dunn* 13

B. The Reasoning of *Eisenberg* and *Welch* is Unsupportable 14

C. The Opinions in This Case Further Expose the Deficiencies in *Eisenberg* and *Welch* and Support the Approach in *Dunn* 16

III. This Case Presents an Important Question of Federal Law Which Should Be Decided by the Supreme Court 17

CONCLUSION 18

APPENDIX 18

Appendix A - Sixth Circuit Opinion - 8/31/04 . . . . 1a

Appendix B - Sixth Circuit Order Staying the Mandate - 11/4/04 . . . . . 4a

Appendix C - District Court Judgment Entry - 5/16/03 . . . . . 6a

Appendix D - District Court Order - 5/2/03 . . . . . 10a

Appendix E - District Court Order - 1/6/03 . . . . . 14a

Appendix F - Business Valuation: Imbedded Capital Gains In C Corporation Holding Companies 23a

TABLE OF AUTHORITIES

Page

Cases

Armstrong v. Marathon Oil Co., 513 N.E.2d 776 (Ohio 1982) 5

Curry v. United States, 706 F.2d 1424 (7th Cir. 1983) 5-6

Davis v. Commissioner, 110 T.C. 530 (T.C. 1998) . 4

Dunn v. Commissioner, 301 F.3d 339 (5th Cir. 2002) . . . . . *passim*

Eisenberg v. Commissioner, 155 F.3d 50 (2d Cir. 1998) . . . . . *passim*

Eisenberg v. Commissioner, No. 17267-95, T.C. Memo 1997-483 (T.C. Oct. 27, 1997) 4

General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935) 3

Gow v. Commissioner, No. 00-2119, 19 Fed. Appx. 90 (4th Cir. Sept. 24, 2001) 17

O'Connell v. Commissioner, 640 F.2d 249 (9th Cir. 1981) 12

Welch v. Commissioner, No. 27513-96, T.C. Memo 1998-167 (T.C. May 6, 1998) 4

Welch v. Commissioner, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. Mar. 1, 2000) . *passim*

Statutes and Regulations

28 U.S.C. § 1254 1

28 U.S.C. § 1332 5

26 CFR § 20.20031-1 . . . . . 1, 5

26 CFR § 25.2512-1 . . . . . 1, 5

Ohio Rev. Code § 1701.85 . . . . . 4, 5

Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 . . . . . 3, 17

Other Authorities

Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (6th ed. 1998) 9, 10, 15

Mark Lee & Gilbert Matthews, "How Should Trapped-In Capital Gains be Valued?" *in Deluxe BV Update* (Aug. 2004) 16

Z. Christopher Mercer, "Imbedded Capital Gains in C Corporation Holding Companies," *Valuation Strategies*, Nov./Dec. 1998 15

Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (4th ed. 2000) 2, 16

PETITION FOR CERTIORARI

OPINIONS BELOW

The opinion of the Court of Appeals (App., *infra*, 1a - 3a) is unreported. The opinion of the District Court (App., *infra*, 10a - 13a) denying Petitioners' motion for reconsideration is reported at 266 F. Supp. 2d 715. The original opinion of the District Court (App., *infra*, 14a - 22a) is reported at 241 F. Supp. 2d 815.

JURISDICTION

The judgment of the Court of Appeals was entered on August 31, 2004. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

REGULATIONS INVOLVED

26 CFR § 20.2031-1(b) provides in relevant part:

> "[F]air market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts."

26 § CFR 25.2512-1 provides in relevant part:

> "The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any

compulsion to buy or to sell, and both having reasonable knowledge of relevant facts."

STATEMENT OF THE CASE

This case raises an important valuation question that arises in a variety of contexts, including federal gift and estate tax and state dissenting shareholder suits. Specifically, what is the appropriate treatment of built-in capital gains when valuing a closely held C-corporation under the net asset valuation method?

A. Built-in Capital Gains and the General Utilities Doctrine

Built-in capital gains occur because many corporations own assets that are likely to appreciate in value, such as real estate or securities. Tax law provides that the owner of appreciated property does not have to pay taxes on this increase in value (*i.e.*, the tax is not recognized) until the property is sold. A disconnect occurs, however, with regard to corporations. Because the corporation owns the underlying asset, transfer of stock does not trigger immediate recognition of the tax. Nonetheless, the corporation's interest in that asset (and, hence, the new shareholder's *pro rata* interest in that asset) is not equal to the market value of that asset, but, rather, the market value *minus* any capital gains tax that must be recognized when the asset is sold.

Accounting for this "built-in" capital gain can be critical to valuing closely held C-corporations. Generally, there are three accepted methods of valuation: market, income and net asset. *See* Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* 45 (4th ed. 2000) ("*Valuing a Business*"). Both the market method and

the income method are generally utilized in the valuation of a viable ongoing enterprise even though, in the context of a closely held company, market guidelines may be limited. However, if the subject company is not a viable ongoing enterprise, the net asset method is generally the primary method utilized. Because the net asset method assumes the sale of the company's assets, built-in capital gains become a factor in the valuation.

Prior to 1986, the treatment of built-in capital gains remained uncontroversial. In *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 206 (1935), this Court concluded that a corporation did not have to pay taxes on appreciated property distributed to shareholders. Later formally adopted into the Internal Revenue Code, the "General Utilities doctrine operated as an exception to the double taxation that applied to C corporations and their shareholders . . . . By employing the General Utilities doctrine, a corporation could liquidate and distribute appreciated or depreciated property to its shareholders without recognizing built-in gain or loss . . . ." *Eisenberg v. Commissioner*, 155 F.3d 50, 54 (2d Cir. 1998) (citations omitted). Accordingly, the Tax Court historically had concluded that, when using the net asset valuation method, no reduction for built-in capital gains was warranted *unless* a tax-triggering event, such as sale of the assets, was likely to occur. *Id.* at 53-54 (citations omitted).

Congress abrogated the General Utilities doctrine in the Tax Reform Act of 1986 ("TRA"), Pub. L. No. 99-514, § 631, 100 Stat. 2085, 2269 (codified in various sections of 26 U.S.C.). *See also Eisenberg*, 155 F.3d at 54-55 (noting that the "TRA removed a corporation's ability to avoid recognition of a gain on the distribution of appreciated property to its shareholders"). Yet until 1998, the Internal

Revenue Service and the Tax Court continued to adhere to their pre-TRA position that recognition of built-in capital gains was improper unless a sale of assets was likely. *See, e.g.*, *Welch v. Commissioner*, No. 27513-96, T.C. Memo 1998-167 (T.C. May 6, 1998) ("We find that in this case the potential for capital gains tax recognition was too speculative to warrant application of the capital gains discount."); *Eisenberg v. Commissioner*, No. 17267-95, T.C. Memo 1997-483 (T.C. Oct. 27, 1997) (holding that "it is inapposite to apply a discount for potential capital gain taxes when the recognition event itself is purely speculative").

Since 1998, federal courts, including the Tax Court, have concluded that some recognition of built-in capital gains is proper when using the net asset methodology, even if a sale of assets is not contemplated or likely. *See, e.g.*, *Eisenberg*, 155 F.3d at 59; *Davis v. Commissioner*, 110 T.C. 530, 550 (T.C. 1998). But as discussed in more detail, *infra*, federal courts do not agree on *how* to account for built-in capital gains.

B. Factual and Procedural History in the Present Case

Martin Bros. Container & Timber Products Corp. ("Martin Bros.") manufactures wirebound containers for transporting machinery parts. Respondents are shareholders in Martin Bros. On July 19, 2000, the majority of shareholders, over the Respondents' objections, merged Martin Bros., then an Ohio corporation, into a Tennessee corporation of the same name.

Respondents, in turn, filed suit in the District Court for the Northern District of Ohio, seeking relief under Ohio's

dissenting shareholder provision, Ohio Rev. Code § 1701.85.[1] This section provides that upon the occurrence of certain corporate events, such as a merger, a dissenting shareholder may demand payment of the "fair cash value" of his or her shares. *Id.* at § 1701.85(A). If the shareholder and corporation are unable to come to an agreement, the shareholder may file suit. *Id.* at § 1701.85(B). The Ohio Revised Code – similar to the federal gift and estate tax provisions, 26 CFR § 20.2031-1(b) (estate tax); 26 CFR § 25.2512-1 (gift tax) – defines fair cash value as "the amount that a willing seller, under no compulsion to sell, would be willing to accept, and that a willing buyer, under no compulsion to purchase, would be willing to pay" for the shares in question. Ohio Rev. Code § 1701.85(C).[2] "It is well established that the willing buyer-willing seller rule presumes that the potential transaction is to be analyzed from the viewpoint of a hypothetical buyer whose only goal is to

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[1] The District Court had subject matter jurisdiction under 28 U.S.C. § 1332 – the plaintiffs residing in Oregon and Michigan, the defendants residing in Ohio, Tennessee and Louisiana and the amount in controversy exceeding $75,000.

[2] The Ohio Supreme Court has noted that the present definition of fair cash value in § 1701.85(C) was added in response to a prior decision equating fair cash value with intrinsic value. *Armstrong v. Marathon Oil Co.*, 513 N.E.2d 776, 785 (Ohio 1982). According to *Armstrong*, the current standard (*i.e.*, the willing buyer, willing seller standard) "is one that is found in a great mass of judicial decisions both in Ohio and elsewhere, *in litigation involving* the value of property, in appropriation suits, *tax controversies*, and other legal proceedings in which property must be valued." *Id.* (emphasis added) (quoting comments of the Ohio State Bar Association committee).

maximize his advantage." *Curry v. United States*, 706 F.2d 1424, 1428 (7th Cir. 1983) (citations omitted).

The District Court conducted a hearing and received evidence on the value of Respondents' shares of Martin Bros. In this regard, the Court noted that all three appraisal experts "agreed that the net asset method of evaluation was appropriate." 241 F. Supp. 2d at 816. It appears this method was selected because Martin Bros. had been suffering operating losses and, as a result, hemorrhaging assets since 1995. *Id.*[3] In other words, the net asset method was the only valuation method that produced a positive value for Martin Bros.

Turning to the built-in capital gains issue, the District Court concluded that some deduction was merited, but that the *entire* amount of the built-in capital gains liability should *not* be deducted. *Id.* at 817-18. The District Court based its conclusion on an unpublished Sixth Circuit decision, *Welch v. Commissioner*, No. 98-2007, 2000 U.S. App. LEXIS 3315 (6th Cir. Mar. 1, 2000), which as discussed in more detail, *infra*, relied heavily on the Second Circuit's opinion in *Eisenberg*.

Analyzing the economic prospects of Martin Bros., the District Court concluded

> that it is more likely than not that the company will be out of business, at the latest, by December 31, 2007. I also conclude that it is more likely than not that the Louisiana land will be sold, at the latest, by December

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[3] Specifically, the company had been selling securities in order to keep the container factory operational.

> 31, 2012. In the interim, it is also more likely than not that other assets (the securities) will be sold to keep the company going for the next five years at the same rate that they have been sold since 1995, and that when the land is sold, the remaining securities will be sold and the proceeds and whatever else remains of the company's assets will be distributed to the shareholders.

241 F. Supp. 2d at 818-19. In this context, the District Court held that, when determining the value of Respondents' shares, Martin Bros.' built-in capital gains liability should be reduced to its present value, with this discounted amount based on the Court's findings as to when assets would be sold. *Id.* at 819.

Martin Bros. filed a motion for reconsideration, which the District Court denied. 266 F. Supp. 2d at 717. Martin Bros. then filed an appeal with the Sixth Circuit. In an unpublished, *per curiam* opinion, the Sixth Circuit adopted the reasoning of the District Court in full, noting that "the issuance of a full written opinion by this court would be duplicative and serve no useful purpose." No. 03-3805, 2004 U.S. App. LEXIS 19100, at *4 (6th Cir. Aug. 31, 2004). No petition for rehearing or petition for rehearing *en banc* was filed.

REASONS FOR GRANTING THE PETITION

The Court should grant *certiorari* in this case to resolve the circuit conflict over the proper treatment of built-in capital gains and provide doctrinal clarity to an important question of federal law. With regard to the treatment of built-in capital gains, the Second Circuit and Sixth Circuit – in *Eisenberg* and *Welch*, respectively – have endorsed positions at odds with the Fifth Circuit's recent decision in *Dunn v. Commissioner*, 301 F.3d 339 (5th Cir. 2002). Examination reveals that *Dunn*

is premised on a rigorous analysis of valuation methodology. In contrast, the unexplained conclusions in both *Eisenberg* and *Welch* seemingly are at odds with these valuation standards. Further, the District Court's decision demonstrates that the approach in *Eisenberg* and *Welch* allows grossly inequitable results and calls upon federal courts to assume the role of business consultants and make arbitrary business judgments concerning the operation and liquidation of closely held companies.

I. The Circuits are Divided Over the Proper Treatment of Built-in Capital Gains

Led by the Second Circuit's decision in *Eisenberg*, several courts (including the District Court and Sixth Circuit in this case) have concluded that only a portion of built-in capital gains should be recognized when using the net asset valuation method. In contrast, the Fifth Circuit's position is that, under the net asset valuation method, a dollar for dollar recognition is required.[4]

A. Eisenberg and Progeny Reject Dollar for Dollar Recognition of Built-in Capital Gains

The dispute in *Eisenberg* arose when Irene Eisenberg gifted shares of a closely held C-corporation to her son and

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[4] It appears as if even the IRS does not always take a consistent position. In at least one instance, the IRS presented the testimony of an expert witness who concluded (similar to the Fifth Circuit) that, when valuing a closely held corporation's interest in publicly traded stock, full recognition of built-in capital gains was appropriate. *Simplot v. Commissioner*, 112 T.C. 130, 166 n.22 (T.C. 1999), *rev'd on other grounds* 249 F.3d 1191 (9th Cir. 2001).

two grandchildren. The sole asset of the corporation was a commercial building, which was leased to third parties. In valuing the stock for gift tax purposes, *Eisenberg* reduced the value of the stock by the full amount of the capital gains tax the corporation would have owed had it sold this building. The IRS objected to this treatment.

In reversing the decision of Tax Court, the Second Circuit noted:

> Our concern in this case is not whether or when the donees will sell . . . the property at issue, but what a hypothetical buyer would take into account . . . . We believe it is common business practice and not mere speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, *would take some account* of the tax consequences of contingent built-in capital gains on the sole asset of the Corporation at issue in making a sound valuation of the property.

Eisenberg, 155 F.3d at 57 (emphasis added).

As implied from this language, *Eisenberg* does not go so far as requiring an immediate dollar for dollar recognition of built-in capital gains. In fact, *Eisenberg* is either confused or hostile to such a position.

In the course of its opinion, the Second Circuit cited an example from a leading tax treatise. *See* Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders* (6th ed. 1998) ("Bittker").

> An example set forth in Bittker also illustrates this point. In the example, A owns 100% of the stock of

> X corporation, which owns one asset, a machine with a value of $1,000 and a basis of $200. Bittker assumes a 25% tax rate and points out that if X sells the machine to Z for $1,000, X will pay tax of $200 on the $800 gain. Bittker adds that if Z buys the stock for $1,000 "on the mistaken theory that the stock is worth the value of the corporate assets," Z will have lost $200 economically "because it paid too much for the stock, failing to account for the built-in tax liability (which can be viewed as the potential tax on disposition of the machine, or as the potential loss from lack of depreciation on $800 [of] basis that Z will not enjoy)." Because of Z's loss, Bittker concludes, 'Z will want to pay only $800 for the stock, in which event A will have effectively 'paid' the $200 built-in gains tax."

Eisenberg, 155 F.3d at 58 n.15 (quoting Bittker at § 10.41[4]).

Based on this example, *Eisenberg* stated "[o]ne might conclude . . . that the full amount of the potential capital gains tax should be subtracted from what would otherwise be the fair market value of the real estate." *Id.* The Second Circuit, however, declared that "[t]his would not be a correct conclusion," *id.*, thereby indicating that full recognition of built-in capital gains is not appropriate.

The Sixth Circuit's decision in *Welch* involved an estate tax dispute, the decedent being a minority shareholder in two closely held corporations. When filing the estate tax return, the executor of Welch's estate reduced the value of the stock to reflect built-in capital gains tax liability.

Like *Eisenberg*, *Welch* concluded that recognition of the entire amount of built-in capital gains was not appropriate. *See* 2000 U.S. App. LEXIS at *17 ("The proper approach in cases of this nature is *not* to deduct the built-in capital gains tax from the value of the appreciated real estate – as petitioners sought to do in the present case . . . ." (emphasis added)). Indeed, *Welch* relied heavily on *Eisenberg*, even quoting footnote fifteen of *Eisenberg* in its entirety. *Id.* at *17-18.

Finally, the District Court relied exclusively on *Welch* in concluding that full recognition of built-in capital gains was unwarranted. *See* 241 F. Supp. 2d at 817 ("In *Welch* the court rejected the contention, similar to that made by defendants here, that the entire amount of the built-in capital gains liability was automatically to be deducted from the value of the shares at issue."). As noted previously, the Sixth Circuit adopted the reasoning of the District Court without explanation or qualification.

B. *Dunn* Requires Full Recognition of Built-in Capital Gains as a Matter of Law

The Fifth Circuit's decision in *Dunn* marks a departure from the approach of *Eisenberg* and *Welch*, both as to the treatment of built-in capital gains and as to the appropriate standard of review.

Dunn was an estate tax dispute. In determining the value of the stock in question, the Tax Court calculated the company's value under both the net asset method and the income, or earnings-based, method. 301 F.3d at 346-47. The Tax Court then took a weighted average of these two amounts. *Id.* at 347. In calculating the company's value under the net asset method, however, the Tax Court utilized

a 5% factor for built-in capital gains, not the actual 34% capital gains rate. *Id.*

On appeal, the Fifth Circuit reversed the holding of the Tax Court. According to the Fifth Circuit, a hypothetical buyer of the decedent's stock "would demand a reduction in price for the built-in gains tax liability of the Corporation's assets at essentially 100 cents on the dollar, regardless of his subjective desires or intentions regarding use or disposition of the assets." *Id.* at 352. In this context, *Dunn* held "*as a matter of law* that the built-in gains tax liability . . . must be considered as a dollar-for-dollar reduction when calculating the asset-based value" of the company. *Id.* at 352-53 (emphasis added).

Dunn thus creates two conflicts. First, it diverges from *Eisenberg* and the Sixth Circuit's *de facto* position (as espoused in *Welch* and in this case) with regard to the treatment of built-in capital gains. Second, *Dunn* is unique in deciding the issue as a matter of law. *Id.* at 351 ("We therefore begin by examining *de novo* the method employed by the Tax Court for dealing with the built-in tax liability of assets in connection with the asset-based approach to value."). Courts have consistently held that valuation issues are questions of fact, to be determined from the circumstances of each case and to be reviewed for clear error. *See Eisenberg*, 155 F.3d at 53 n.9 (quoting Revenue Ruling 59-60, 1959-1 C.B. 237); *Davis*, 110 T.C. at 537 ("As the trier of fact, we have broad discretion in assigning the weight to accord to the various factors and in selecting the method of valuation." (citing *O'Connell v. Commissioner*, 640 F.2d 249, 251-52 (9th Cir. 1981)).

II. *Dunn* is the Superior Approach and Supported by Appraisal Standards

As *Dunn* properly recognized, the treatment of built-in capital gains is dictated by the valuation method selected. In the case of the net asset valuation method, the underlying assumption is that the assets are going to be sold. *Eisenberg* and *Welch* ignored this principle, and the decision of the District Court in this case demonstrates the folly of such a position.

A. The Reasoning of *Dunn*

In *Dunn,* the Fifth Circuit criticized the Tax Court's reliance (similar to the District Court's reliance in this case) on the fact that liquidation of the company's assets was not imminent. The Fifth Circuit noted that the timing or likelihood of liquidation is a "red herring," 301 F.3d at 352, and involves the "quintessential mixing of apples and oranges." *Id.* at 353. The "'real world' likelihood of liquidation is not a factor affecting built-in tax liability when conducting the asset-based approach." *Id.* at 354.

The explanation for this position lies in the assumptions underlying the net asset method itself.

> By definition, the asset-based value of a corporation is grounded in the fair market value of its assets . . ., which in turn is determined by applying the venerable willing buyer-willing seller test. By its very definition this contemplates the consummation of the purchase and sale of the property, *i.e.*, the asset being valued.

Id. at 353. Put differently, when the valuation process depends on a "sub-determination based on the value of the

company's assets," the value of these assets "must be tested in the same willing buyer/willing seller crucible." *Id.* For purposes of the net asset method, therefore, the assumption is that the assets will be sold, meaning the likelihood of liquidation is one hundred percent. *Id.*

This conclusion is further supported by the assumptions underlying the income, or net cash flow, method. As the Fifth Circuit recognized, the "fundamental assumption in the income or cash-flow approach is that the assets are retained by the Corporation, *i.e.*, not globally disposed of in liquidation or otherwise." *Id.* Thus, the prospect of liquidation has no bearing on the income valuation method either.

The final step in the *Dunn* methodology is reconciling the values obtained by the two approaches. In this step, the prospect of liquidation becomes relevant in determining the weight to be given to each of the two approaches. "The lesser the likelihood of liquidation . . ., the greater the weight that must be assigned to the earnings (cash flow)-based approach and, perforce, the lesser the weight to be assigned to the asset-based approach." *Id.* at 354.

B. The Reasoning of *Eisenberg* and *Welch* is Unsupportable

The preceding discussion demonstrates the systematic and logical approach to valuation advocated by *Dunn*. By contrast, *Eisenberg* and *Welch* never explain why built-in capital gains are only partially recognized when using the net asset method to value stock.

As quoted at length in Section I.A., *supra*, footnote fifteen of *Eisenberg*, adopted in full by *Welch*, sets forth an example

from Bittker in which a hypothetical buyer must decide between purchasing a company's stock or purchasing the underlying asset. 155 F.3d at 58 n.15. The Second Circuit then states that, based on this example, one might be tempted to conclude that built-in capital gains should be deducted in full, but that this conclusion would be incorrect. *Id.*

Neither *Eisenberg* nor *Welch* cite any authority for this leap in logic. The only rationale provided is that there is a difference between valuing the stock and valuing the underlying asset: "In this case, we are only addressing how potential tax consequences – the capital gains tax – may affect the fair market value of the shares of stock appellant gifted to her relatives[,] in contrast to the fair market value of the real estate." *Id.* Yet *Eisenberg* and *Welch* fail to explain *why*, under the net asset valuation method, valuing the underlying asset is analytically distinct from valuing the stock. By comparison, *Dunn* recognizes the assumption underlying the net asset valuation method is that the hypothetical buyer purchases stock *to obtain the underlying assets*. 301 F.3d at 352.

Indeed, the Bittker example notes that, while a rational buyer would pay $1,000 for a machine, the same buyer would pay only $800 for the stock of a company owning the machine because of the company's built-in capital gains. Bittker at § 10.41[4]. Therefore, Bittker instructs that the hypothetical buyer and seller, neither being under compulsion to buy or sell, will agree on a price in which each is indifferent between purchasing and selling the stock and purchasing and selling the underlying assets. As many appraisal experts have recognized, this translates into full recognition of built-in capital gains under the net asset valuation method. *See,* Z. Christopher Mercer, "Imbedded Capital Gains in C Corporation Holding Companies," *Valuation Strategies*,

Nov./Dec. 1998, at 41 (conducting analysis and concluding that built-in capital gains should be treated as a present liability with no sharing of the liability between the sellers and the buyers of the stock).

C. The Opinions in This Case Further Expose the Deficiencies in *Eisenberg* and *Welch* and Support the Approach in *Dunn*

Respondents owned only a minority interest in Martin Bros. Generally, appraisers value minority ownership interests using the income valuation method, not the net asset valuation method. *See* Pratt, *Valuing a Business* at 34 ("If valuing a minority ownership interest, one would normally adopt the premise of 'business as usual . . . .'"); *id.* at 443 ("The asset-based approach tends to be more appropriate when valuing a controlling ownership interest than a noncontrolling ownership interest."). And as noted earlier, Martin Bros. would be losing money and cannibalizing assets until liquidation. Thus, the decision to use the net asset valuation method exclusively benefited Respondents by producing the highest possible value for their shares.

In this context, the District Court (and, hence, the Sixth Circuit) either confused valuation methods or adhered to none. With regard to valuing Martin Bros.' assets, the District Court assumed these assets would be sold at full value as of the valuation date. Yet at the same time, the District Court reduced Martin Bros.' liabilities by using the present value of built-in capital gains obligations. In addition, the District Court improperly assumed for itself the role of consultant and exercised its own form of business judgment in speculating how long Martin Bros. could operate and when it would liquidate. *See* Mark Lee & Gilbert Matthews, "How Should Trapped-In Capital Gains be Valued?" *in Deluxe*

BVUpdate (Aug. 2004) (concluding that, based on their analysis, calculating the present value of built-in capital gains is "analytically incorrect and has no general validity"). *Eisenberg* and *Welch* legitimize such an inequitable and irrational outcome. In contrast, *Dunn*, by mandating the full recognition of built-in capital gains, prevents such a result.

III. This Case Presents an Important Question of Federal Law Which Should Be Decided by the Supreme Court

It has been almost twenty years since the Tax Reform Act of 1986 revoked the General Utilities doctrine. Courts, however, still have not provided the necessary guidance to practitioners in the field. When not taking conflicting positions, the federal judiciary has chosen not to grapple with the issue at all. The Sixth Circuit's opinion in this case and the Fourth Circuit's opinion in *Gow v. Commissioner*, No. 00-2119, 19 Fed. Appx. 90, 96-97 (4th Cir. Sept. 24, 2001) (rejecting appellant's built-in gains tax argument on appeal and simply declaring that, "upon careful and thorough review of the Tax Court's decision," that the Court's findings and methodology were not clearly erroneous), are good examples of this phenomenon.

The appropriate treatment of built-in capital gains when valuing closely held corporations, while not glamorous, will become only more important. As one generation of closely held business owners pass away, another is looking to redeem or gift away stock in anticipation of retirement, while a third looks to rekindle, after a cycle of relative dormancy, the merger and acquisition craze. In all of these areas, valuation issues, and the treatment of built-in capital gains, will be of vital importance. Accordingly, the Court should decide this long unsettled question.

CONCLUSION

For the reasons set forth above, the Court should grant this petition for a *writ* of *certiorari*.

Respectfully Submitted,

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APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Case No. 03-3805

[Filed August 31, 2004]

RAYMOND J. MARTIN, ET AL.,
Plaintiffs-Appellees

v.

MARTIN BROS. CONTAINER & TIMBER PRODUCTS CORP., ET AL.,
Defendants-Appellants

BEFORE: KEITH, MARTIN, and ROGERS, Circuit Judges.

OPINION BY: KEITH, MARTIN, ROGERS

OPINION

PER CURIAM. This matter arose as a "special proceeding" under Ohio Revised Code § 1701.85, which provides a remedy for minority shareholders when a corporation takes certain actions from which the minority shareholders dissent. In this case, Defendants-Appellants Martin Brothers Container & Timber Products ("the

Company"), scheduled a special meeting of the Company's shareholders for the purpose of considering a motion to merge the Company, an Ohio corporation, into a Tennessee corporation of the same name. The shareholders constituting the majority voted for the merger.

Plaintiffs-Appellees Raymond J. Martin, Dolores J. Martin, and Cecelia A. Austin (collectively "Plaintiffs") voted against the merger and, as required by statute, thereafter timely demanded that the Company purchase their interest in the Company. After the Company refused to purchase the tendered stock, Plaintiffs commenced with the special proceeding which, under the statute, would determine the value of their stock, set interest at an equitable rate from an equitable date, and require the Company to pay the resulting sum within sixty days of the date of such judgment. On October 16, 2000, Plaintiffs filed a Verified Complaint to Determine Fair Cash Value of Shares in the district court. After discovery, on November 5, 2002, a one-day bench trial was held before United States District Court Judge James G. Carr.

On January 6, 2003, after reviewing the post trial briefs submitted by the parties, the district court entered certain findings and conclusions and directed the parties to file revised statements of valuation. On February 7, 2003, after reviewing the revised statements of valuation, the district court again entered certain findings and conclusions determining the valuation. On May 2, 2003, after reviewing the briefs regarding interest, as well as the Company's motion for reconsideration, the district court directed the Plaintiffs to submit a judgment entry stating the amount of the award in their favor, including interest. On May 21, 2003, the district court entered judgment in favor of the Plaintiffs in the amount

of $1,827,029.00, plus 6% interest from July 18, 2000. The Company filed a timely notice of appeal on May 30, 2003.

Having had the benefit of oral argument, and having carefully considered the record on appeal and the briefs of the parties, we are not persuaded that the district court erred in its decisions. As the reasons for the decisions have been articulated by the district court, the issuance of a full written opinion by this court would be duplicative and serve no useful purpose.

Accordingly, we adopt the reasoning of the district court as set forth in its order filed on January 6, 2003, and affirm that order as well as district court's subsequent findings and conclusions determining the valuation of the Plaintiffs' stock.

APPENDIX B

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Case No. 03-3805

[Filed November 4, 2004]

RAYMOND J. MARTIN, ET AL., Plaintiffs-Appellees	)
v.	)
MARTIN BROS. CONTAINER & TIMBER PRODUCTS CORP., A TENNESSEE CORPORATION, Defendants-Appellants	)

Before: KEITH, MARTIN, and ROGERS, Circuit Judges.

Upon consideration of appellant's motion to stay mandate,

It is ORDERED that the mandate be stayed to allow appellant time to file a petition for a writ of certiorari, and thereafter until the Supreme Court disposes of the case, but shall promptly issue if the petition is not filed within ninety days from the date of final judgment by this court.

Entered By Order of the Court

/s/_____
Leonard Green, Clerk

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
WESTERN DIVISON

Case No. 3:00CV7642

[Filed May 16, 2003]

RAYMOND J. MARTIN, ET AL., Plaintiffs,	)
v.	)
MARTIN BROS. CONTAINER & TIMBER PRODUCTS CORP., ET AL., Defendants.	)

JUDGE: James G. Carr

JUDGMENT ENTRY

This is a diversity action brought by certain minority shareholders ("Plaintiffs") of defendant Martin Bros. Container & Timber Products Corp. ("Martin Bros.") as a "special proceeding" under Section 1701.85(B) of the Ohio Revised Code to determine "the fair cash value" of Plaintiffs' stock in Defendant. The court makes the following

determination of the fair cash value of the stock held by Plaintiffs in Martin Bros.:

Value of the Stock on July 18, 2000

Total Assets	$8,431,963	
Present Value of tax on gains	536,969	
Other Liabilities	681,969	
Deferred Compensation	184,385	
Total Liabilities	$1,413,323	
Net Asset Value	$7,018,841	
Less Preferred Shares @ $100 per share	597,870	
Net Value of Common Shares	$6,420,771	
Total Common Shares	11,676	
Fair ash Value per share		$549.91
Less Minority Discount @ 15%		82.49
		467.42
Less Marketability Discount @ 30%		$140.23
Net Value of Plaintiffs' Common Shares		$327.19
Preferred		$100.00

Raymond J. Martin:

Common Shares:	1417
Common Stock:	451,296.00
Preferred Shares:	2118.8
Preferred Stock $100:	211,890.00
Total:	893,186.00

Dolores Martin:

Common Shares:	1609
Common Stock:	493,730.00
Preferred Shares:	
Preferred Stock $100:	
Total:	493,730.00

Cecelia Austin:

Common Shares:	1700
Common Stock:	556,223.00
Preferred Shares:	838.9
Preferred Stock $100:	83,890.00
Total:	840,113.00

Total:	1,827,029.00

This court further finds that interest shall be paid on the above-stated values from July 18, 2000 to May 15, 2003, at the rate of 6%, compounded annually.

IT IS, THEREFORE, ORDERED that plaintiff Raymond J. Martin is hereby awarded judgment against Defendant Martin Bros. In the amount of Six Hundred Ninety-three Thousand One Hundred Eighty-six and 00/100 Dollars ($693,186.00) plus interest of One Hundred Twenty-four

Thousand Two Hundred Fifteen and 54/100 Dollars ($124,615.54) for a total of Eight Hundred Seventeen Thousand Four Hundred One and 54/100 Dollars ($817,401.54) to the date of this Order; Dolores Martin is awarded judgment against the Defendant Martin Bros. In the amount of Four Hundred Ninety-three Thousand Seven Hundred Thirty and 00/100 Dollars ($493,730.00) plus interest of Eighty-eight Thousand Four Hundred Seventy-four and 00/100 Dollars ($88,474.00) for a total of Five Hundred Eighty-two Thousand Two Hundred Four and 00/100 Dollars ($582,204.00) to the date of this Order; and Cecelia Austin is awarded judgment against the Defendant Martin Bros. in the amount of Six Hundred Forty Thousand One hundred thirteen and 00/100 Dollars ($640,113.00) plus interest of One Hundred Fourteen Thousand Seven Hundred Eighteen and 12/100 Dollars ($114,705.12) for a total of Seven Hundred Fifty-four Thousand Eight Hundred Eighteen and 12/100 Dollars ($754,818.12) to the date of this Order.

In addition, the Defendant shall pay Plaintiffs the sum of Two Thousand Dollars ($2,000.00) for their attorney fees per this Court's Order of May 2, 2003.

The judgments rendered herein shall bear interest from the date of this Order at the rate set forth under 28 U.S.C. 1961 of 1.23%.

Dated: May 16, 2003

/s/_____
James G. Carr
United States District Judge

APPENDIX D

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

Case No. 3:00CV7642

[Decided May 2, 2003]

Raymond J. Martin, et al.,	)
Plaintiffs	)
	)
v.	)
	)
Martin Bros. Container	)
& Timber Products	)
Corporation, et al.,	)
Defendants	)
	)

James G. Carr, United States District Judge.

ORDER

This is a diversity suit by minority shareholders in the defendant Martin Bros. Container & Timber Products Corporation as a "special proceeding" under § 1701.85(B) of the Ohio Revised Code to determine the fair market value of the plaintiffs' shares in the corporation. Following a non-jury trial, I entered certain findings and conclusions as to disputed

issues and the value of the minority shares. (Doc. 56). The parties were ordered to submit proposed judgment entries incorporating those findings and my conclusions as to valuation and related interest computations. (*Id.*).

The parties have submitted those proposals, which, not surprisingly, are in substantial disagreement. In addition, the defendants have filed a motion for reconsideration (Doc. 62) and a motion to strike an affidavit attached to the plaintiffs' reply brief re. their interest computation. (Doc. 70).

For the reasons that follow, I overrule motion to strike, deny the motion for reconsideration (and impose attorneys' fees against the defendants for having filed said motion), and make the following determinations regarding the rate and starting date for interest on the value of the plaintiffs' shares, as previously ascertained.

Turning first to the motion to strike: that motion is overruled because the affidavit which it challenges played no role in my determination of the appropriate rate of or starting date for interest in plaintiffs' favor. The motion is, accordingly, moot.

The defendants' motion for reconsideration challenges the deduction for taxes, which I computed at 34%. Defendants contend, as they did in their original briefs, that the rate for such deduction should be 40%.

As plaintiffs' opposition points out, most of what defendants assert in their motion for reconsideration was not presented to me when I first considered the issue of valuation. That material could and should have been presented to me in a timely fashion; because it was not, I decline to consider it now. To the extent that the motion for reconsideration re-

argues contentions that were previously considered, I decline to revisit issues which I already examined closely and in detail. If I erred in my result, it is for the court of appeals to say so, and not for me to undertake to determine when presented with arguments I considered before.

Because I find no basis for reconsidering my earlier decision, the judgment to be awarded herein shall be increased in the amount of $2,000 as and for attorneys' fees incurred by the plaintiffs in opposing the defendants' motion for reconsideration. See generally, *American Trim, LLC. v. Oracle Corp.*, 230 F. Supp.2d 803, 804 (N.D. Ohio 2002); *Miller v. Norfolk Southern Rwy. Co.*, 208 F. Supp.2d 851, 853 (N.D. Ohio 2002); *McConocha v. Blue Cross and Blue Shield Mut. of Ohio*, 930 F. Supp. 1182, 1183 (N.D.Ohio 1996).[1] imposition of sanctions ab initio. By estimating the fees incurred by plaintiffs in responding to defendants' motion

Under § 1701.85(B) interest is to be awarded "at such rate and from such date as the court considers equitable." In light of the arguments of the parties and the authorities they have cited in their briefs, I conclude that interest at the rate of six

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[1] If, rather than abiding by my ad hoc assessment of the fees likely to have reasonably incurred by plaintiffs in opposing the motion for reconsideration, defendants want to have plaintiffs submit a statement re: such fees, they shall serve notice of such request within ten days of the entry of this order. If, after considering such submission, I conclude that such amount, or one reasonably close to it, is appropriate, defendants shall be further assessed the fees incurred by plaintiffs in responding to such challenge. If defendants abide by the amount of the assessment herein, it will be without prejudice to their right to challenge the for reconsideration, I am simply trying to avoid further unnecessary expenditure of time and money on the part of all concerned.

percent per annum, compounded, should run from July 18, 2000, the date immediately prior to the merger which has necessitated these proceedings. Under all the circumstances, and in light of the decline in interest rates generally and steadily since that date, six percent compounded is equitable, and a more reliable benchmark than the lower rates proposed by the defendants and the higher rates proposed by the plaintiffs.

I agree with the plaintiffs that the starting date for interest is the date prior to the merger. From that point the parties were deadlocked - nothing changed between that date and the entry of my valuation findings and conclusions. Without assessing blame for that situation, I conclude that plaintiffs can best be made whole, and equity and fairness are best served, by starting the interest clock on that date.

In light of the foregoing, it is

ORDERED THAT by May 15, 2003, plaintiffs shall prepare and file a proposed judgment entry stating the amount of the award to which they are entitled in light of this court's findings and conclusions re: valuation and interest, and, with regard to the defendants' motion for reconsideration, $2,000 attorneys' fees.
So ordered.

05-02-2003

/s/ _____
James G. Carr
United States District Judge

APPENDIX E

UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF OHIO
WESTERN DIVISION

Case No. 3:00CV7642

[Filed January 6, 2003]

Raymond J. Martin, et al.,	)
Plaintiffs	)
	)
v.	)
	)
Martin Bros. Container	)
& Timber Products Corp., et al.,	)
Defendants	)
	)

James G. Carr, United States District Judge.

ORDER

This is a diversity case brought by minority shareholders in the defendant Martin Bros. Container & Timber Products Corporation as a "special proceeding" under § 1701.85(B) of the Ohio Revised Code to determine the fair market value of the plaintiffs' shares in the corporation. Under that provision, the fair cash value of the plaintiffs' shares is the amount that a willing seller under no compulsion to sell would be willing

to accept and a willing buyer under no compulsion to sell would be willing to pay for those shares. *Armstrong v. Marathon Oil Co.*, 32 Ohio St.3d 397, 513 N.E.2d 776 (1987) (Syllabus, ¶ 1).

The corporation is family owned and has been in existence since 1909. It makes wirebound containers from hardwood and veneer for transporting large items, such as metal machinery parts. Due to increases in the price of hardwood and other market forces, the company has had operating losses since 1995. Since 1995 the company's assets have declined, through sales, primarily, of securities. The company's working capital has correspondingly decreased by about sixty percent during this period.

On July 19, 2000, the majority shareholders, over the objections of the plaintiffs, merged Martin Bros. Container & Timber Company, an Ohio corporation, into a Tennessee corporation of the same name. Plaintiffs filed this lawsuit within a few months thereafter.

In addition to its plant and equipment, the corporation owns approximately 13,000 acres of undeveloped land northwest of New Orleans, Louisiana, about $2,000,000 in marketable securities, and a leasehold interest in a parcel of real estate in Martin, Tennessee.

Three experts were retained to provide estimates of the value of plaintiffs' shares: one by the plaintiffs, another by the defendants, and a third, at the court's suggestion in an effort to accomplish a settlement, by the parties jointly. All three experts, each of whom submitted a written report and testified at the non-jury trial of this case, agreed that the net asset method of evaluation was appropriate.

The valuations reached by each were:

Gregory A. Handel, plaintiffs' expert:	$7,735,692
Daniel P. Callanan, defendants' expert:	$5,798,523
Jeffrey M. Risius, the joint expert:	$5,579,196.

The principal disagreements between the experts related to three items: 1) the value of the Louisiana land holdings; 2) the reduction in value in light of a contingent liability for built-in capital gains; and 3) the discount resulting from the minority character of plaintiffs' shareholdings. There are, as well, disputes about the value of other items of lesser value.

1. Louisiana Land

The land is vacant, much of it is marshy or swampy, which limits the extent of prospective development, and the income it generates falls short of covering the annual real estate taxes.

Plaintiffs retained an appraiser who valued the land at $3,250,000 as a fair market value. Defendants retained an appraiser who valued the land at $2,212,720 as a liquidation value and $2,929,000 as a fair market value. There is insufficient evidence in the record to accept the contention that liquidation will be necessary. Thus, the fair market value estimates are more reliable, as defendants appear to concede in their post-trial brief.

Defendants recommend that the land be valued at $3,089,500, the midpoint between the appraisals. Plaintiffs ask that it be valued at $3,250,000 (i.e., in accordance with the estimate of their appraiser). They fail to explain, however,

why that valuation should be chosen over the lower fair market value estimate of the defendants' appraiser.

I conclude that the only sensible resolution of this dispute is to accept the defendants' suggestion that I accept the midpoint between the two fair market value appraisals. The Louisiana land, accordingly, has a value of $3,089,500.

2. Built-in Capital Gains Tax Liability

The parties agree that, were the company's assets to be sold, capital gains tax would have to be paid on the assets' built-in capital gains. They dispute how the amount of such tax is to be computed. Defendants assert that the value of the assets subject to this tax should be reduced by the full amount of the tax, computed as of the valuation date.

Plaintiffs assert that, absent evidence that a sale of some or all the assets is about to occur immediately or within a reasonably short period, the anticipated tax liability should be reduced to present value. In other words, plaintiffs contend that reduction in the value of the assets due to the prospective capital gains tax liability should be less than the full amount of that tax that would be due if the assets were deemed liquidated as of the valuation date.

In *Estate of Pauline Welch v. C.I.R.*, 2000 U.S. App. LEXIS 3315, 2000 WL 263309, (6th Cir. 2000) (Unpublished Disposition), the Sixth Circuit stated that the issue

> is not whether or when the [heirs] will sell, distribute or liquidate the property at issue, but what a hypothetical buyer would take into account in computing fair market value of the stock. We believe it is common business practice and not mere

> speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the Corporation at issue in making a sound valuation of the property.

(Citing *Eisenberg v. Commissioner*, 155 F.3d 50, 57 (2nd Cir.1998)).

In Welch the court rejected the contention, similar to that made by defendants here, that the entire amount of the built-in capital gains liability was automatically to be deducted from the value of the shares at issue. Instead, the court stated,

> The proper approach in cases of this nature is not to deduct the built-in capital gains tax from the value of the appreciated real estate--as petitioners sought to do in the present case--because the question is not what is the value of the real estate, but what is the value of the stock with regard to all the circumstances, including the built-in potential capital gains liability if and when the real estate is sold.

Id.

Some deduction is, however, to be made against the value of the asset because a willing seller and a willing buyer of the stock on the valuation date "would have agreed on a price on the valuation date at which each such block [of stock] would have changed hands that was less than the price that they would have agreed upon if there had been no ... built-in capital gains tax as of that date." 2000 U.S. App. LEXIS 3315, 2000 WL 263309 *id.* at **5 (citing *Davis v. Commissioner*, 110 T.C. 530 (1998)).

In *Welch* the court, noting that "'valuation is necessarily an approximation and a matter of judgment, rather than of mathematics,'" *id.* (citing *Davis*), placed the burden of proof on the party (in that estate tax case, the taxpayer) seeking to benefit from the reduction in value of the asset at issue. *Id.* Taking that approach in this case, I conclude that the defendants should bear the burden of proving how much of the anticipated built-in capital gains tax liability is presently to be applied against the value of the company's assets.

The parties' dispute about the impact of the anticipated capital gains tax liability is bottomed on their differing views about when that liability is likely to accrue. Plaintiffs' expert assumes that it will not accrue for thirty years; defendants' expert and the joint expert assume that it will accrue immediately. Each view is extreme, and neither is persuasive.

There is no reason to believe that this company, riven by dissension among its shareholders, producing a product that is likely to become less, rather than more competitive, possessing only one class of assets (marketable securities) that has any perceptible chance of appreciating significantly with the passage of time, and led by a man in his mid-sixties, is likely to last for thirty years. On the other hand, the likelihood that the company's affairs will be wound up shortly after issuance of this opinion is also unlikely. Nothing in the record manifests any intention or expectation on the part of the majority shareholders that the company is soon to be wound up and have its assets sold off. I agree with the defendants, moreover, that the tax-reduction or avoidance tactics referenced by the plaintiffs' expert (i.e., conversion from a C to an S corporation) are not a realistic means of getting out from underneath, or even significantly reducing, the built-in capital gains tax liability.

On the other hand, the operating asset, the container factory, has lost money consistently since 1995. It has been kept going in the face of increasingly severe market conditions by dissipation of other assets. Peter can be robbed to pay Paul for only so long until there is nothing left for one to take from the other.

I conclude, accordingly, that it is more likely than not that the company will be out of business, at the latest, by December 31, 2007. I also conclude that it is more likely than not that the Louisiana land will be sold, at the latest, by December 31, 2012. In the interim, it is also more likely than not that other assets (the securities) will be sold to keep the company going for the next five years at the same rate that they have been sold since 1995, and that when the land is sold, the remaining securities will be sold and the proceeds and whatever else remains of the company's assets will be distributed to the shareholders.

I conclude, accordingly, that the built-in capital gains tax liability is to be computed on the basis of the present value of that liability as of the valuation date of July 18, 2000 (the day before the merger of Martin Bros. Ohio into Martin Bros. Tennessee).

3. Discount for Lack of Control and Marketability

The parties agree that the value of plaintiffs' shares is affected by their minority status. As a result of that status, they cannot control the fate and fortunes of the company. Because of closed, family-held nature of the business, there is no open and ready market for the shares, which makes them less liquid, and otherwise less attractive to a prospective purchaser.

Lacking any other reliable and potentially unbiased guidance, I accept the valuation of these discounts proposed by the joint expert: namely, fifteen percent for lack of control, and thirty percent for lack of marketability.

4. Other Disputed Items

With regard to the parties' dispute about other items, I conclude, in light of the experts' reports and their testimony, that the opinion of the joint expert as to those items (the leasehold interest, the company's personal property, and deferred compensation) is the most reliable. It is, accordingly, adopted as more likely than not accurately expressing the value properly accorded to those items.

Conclusion

Rather than attempting to compute the value of the plaintiffs' shareholdings in light of the foregoing, I shall direct them to prepare and submit a revised statement of valuation, to which the defendants can respond, if they do not agree with plaintiffs' revision, and to which, in turn, the plaintiffs can reply. At that point this matter will be ready for entry of judgment.

It is, therefore,

ORDERED THAT on or before January 15, 2003, the plaintiffs shall, in light of the foregoing findings and conclusions, file a revised statement of valuation; if the defendants dispute plaintiffs' revised valuation, they shall file a response on or before January 24, 2003; plaintiffs to reply on or before January 31, 2003.

So ordered.

01/06/2003

/s/ _____
James G. Carr
United States District Judge

APPENDIX F

Business Valuation: Imbedded Capital Gains In C Corporation Holding Companies

Z. Christopher Mercer*

November/December 1998

There has been substantial controversy regarding the appropriate treatment of imbedded capital gains in determining the fair market value of interests in C corporations since the repeal of the so-called *General Utilities* doctrine by the Tax Reform Act of 1986 (TRA '86). The IRS has long held the position that imbedded capital gains, or "trapped-in" gains, are speculative in nature. According to this argument, in the absence of a specific plan for the liquidation of a C corporation's assets, it is inappropriate to consider the imbedded capital gains tax *liability* that will be incurred on liquidation of that corporation's assets. We refer to this argument as the IRS Position.

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* Z. CHRISTOPHER MERCER, ASA, CFA, is president of Mercer Capital, Memphis, Tennessee. The author wishes to thank Kenneth W. Patton, ASA, J. Michael Julius, ASA, CFA, and Matthew R. Crow, AM, for sharing their knowledge and insights on this topic over the years. Any errors, logical, conceptual, or theoretical, however, are the author's alone.

Many business appraisers, on the other hand, have suggested that imbedded capital gains must somehow be considered in valuations of post-1986 C corporation asset holding companies. The crux of their argument is that rational investors would consider the risks and realities of acquiring interests in corporations with significant imbedded gains in their overall investment decision-making processes. This attention would be paid, they argue, regardless of whether a liquidation is imminent, or even reasonably foreseeable, over a relevant investment time horizon. Some appraisers have called for full recognition of imbedded tax liabilities in the valuation of C corporation asset holding companies. We refer to this argument as the Business Appraisers' Position.

Here, we will test both positions and examine whether no consideration, partial consideration, or full consideration of imbedded tax liabilities makes sense in the context of the definition of fair market value. We will:

- Define what imbedded capital gains are in the context of C corporation holding companies.[1]

- Briefly review the impact of the repeal of the *General Utilities* doctrine on valuation.

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[1] The treatment of imbedded capital gains in operating companies or in tax pass-through entities is beyond the scope of this column, although many of the issues discussed are obviously applicable to C corporation operating companies that hold significant appreciated nonoperating (or perhaps operating) assets. While the issue of imbedded gains arises in valuations for many purposes, the following discussion is framed in the general context of gift and estate tax appraisals.

- Review the basic arguments typically advanced in favor of the IRS Position and the Business Appraisers' Position regarding the treatment of imbedded capital gains as a liability in the determination of the net asset value of C corporation holding companies.

- Consider two recent court cases that have leaned strongly in the direction of the Business Appraisers' Position, allowing active consideration of imbedded capital gains taxes.

- Offer logical "proof" that rational investors must consider imbedded gains in their investment decisions regarding the acquisition of interests of C corporations.

What are Imbedded Capital Gains? What are the Questions?

The financial statements of most corporations are maintained on the historical cost basis of accounting. Assets are recorded at their original costs, and then these bases are adjusted over time by depreciation, amortization, capital improvements, and disposals or other transactions that affect carrying value. For asset holding corporations, where assets subject to appreciation are likely to be found (e.g., land, buildings, or investment securities), there can be a growing divergence with the passage of time between the historical "book values" of assets and their current market values.

Example. ABC, Inc., a C corporation, owns a parcel of land with an original cost basis of $100,000. Currently, this land has an appraised fair market value of $1 million. Under current tax law (discussed below), the difference between the

historical cost basis and the current market value, or $900,000 (i.e., $1 million of fair market value less the $100,000 cost basis), represents a capital gain that is "trapped in" at the C corporation level. The gain is said to be trapped-in (or "built-in") because it will be incurred if the parcel of land is sold by the corporation. Such imbedded gains are also referred to as "inside gains," indicating that the gain occurs *inside* the corporation, and must be dealt with before funds are available for shareholders, either via distribution or in liquidation.

The corporation's tax accountant says the tax rate on the imbedded capital gain is 40%. We can now quantify the imbedded capital gain tax *liability* at $360,000 (i.e., the $900,000 imbedded gain times the tax rate of 40%). The fundamental questions raised by the example are:

- Should the $360,000 imbedded tax liability in ABC be considered in the determination of the fair market value of interests in the stock of ABC? (If it should not be considered, this will be a very short column.)

- If the imbedded tax liability should be considered in fair market value determinations regarding ABC, how should it be considered, and what is the economic rationale for its consideration from the viewpoint of hypothetical willing investors? These first two questions deal with *existing* imbedded capital gains.

- There is a third question that appraisers have been reluctant to raise in the face of the controversy regarding the first two questions. We will ask it here as part of the formal economic analysis of imbedded gains that has been missing for so long,

both in business appraisal reports and in Tax Court decisions. What is the appropriate consideration of future capital gains (that will become imbedded as assets appreciate) in determining the fair market value of interests of a C corporation asset holding entity today?

Things are Different After 1986

From about 1935 until the enactment of TRA of '86, corporations generally did not recognize gains on certain distributions of appreciated assets to their shareholders or on certain liquidating sales of property. The policy was based on a doctrine established in *General Utilities & Operating Co.*[2] Under the so-called *General Utilities* doctrine, assets were allowed to leave corporate ownership and to take a stepped-up basis in the hands of shareholders without imposition of a corporate-level tax. Under the *General Utilities* rule, it was usually feasible to avoid paying tax on otherwise trapped-in capital gains by effecting appropriate distributions of the underlying asset. This doctrine was the law of the realm for some 50 years.

With TRA'86,Congress repealed the *General Utilities* doctrine, on the theory that it undermined the corporate income tax. C-corporations and their shareholders have been dealing with the reality of the repeal of *General Utilities* ever since.

Prior to 1986, business appraisers and investors were not overly concerned with the issue of imbedded capital gains. The reason was straight-forward: Significant imbedded

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[2] 296 U.S. 200, 16 AFTR 1126 (1935).

capital gains tax liabilities were avoidable through generally available elections under the *General Utilities* doctrine, such as the election under former Section 337.

Since 1986, the IRS has cited numerous Tax Court cases that disallowed consideration of imbedded capital gains tax liabilities in fair market value determinations.[3] Virtually all the cases frequently cited by the IRS deal with *pre-1986 valuation dates*. To jump ahead a little, we quote the very recent Second Circuit *Eisenberg*[4] case, which is discussed in more depth below: Now that the TRA has effectively closed the option to avoid capital gains tax at the corporate level, reliance on these cases, in the post-TRA environment should, in our view, no longer continue.

So, things are different economically since 1986 with respect to the imbedded capital gains issue. However, until recently, the IRS and the Tax Court have consistently reasoned (at least in substance) that they are not.

The IRS Position

The basic arguments by the IRS for not considering the valuation impact of imbedded capital gains have been consistent and simple:

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[3] See, e.g, *Estate of Andrews*, 79 TC 938 (1982); *Estate of Piper*, 72 TC 1062 (1979); *Estate of Cruikshank*, 9 TC 162 (1947); *Estate of Luton*, TCM 1994-539 ; *Estate of Bennett*, TCM 1993-34; *Gallun*, TCM 1974-284. These and other cases have often been cited by the IRS in Tax Court cases, as well as argued in various settlement negotiations with taxpayers and their professional representatives.

[4] 82 AFTR2d 98-5617 (CA-2, 1998), *rev'g* TCM 1997-483.

- Unless a liquidation of the underlying assets is imminently contemplated, the consideration of imbedded capital gains is "speculative." If the gain is speculative, it should not be considered today.

- The economic argument is that the gain might never be realized and the tax might never be paid because no liquidation is presently contemplated. Further, if the tax is ultimately paid, it might happen at such a distance in the future that its present value would be minimal. Therefore, according to the IRS Position, imbedded capital gains should not be considered in fair market value determinations.[5]

- Imbedded capital gains can be avoided by having a C corporation make an S election. Under transition rules, if the gains are realized ten years or more following the S election, they are subject to only the pass-through, shareholder-level personal tax.[6]

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[5] Has anyone advocating the IRS Position ever made any pro forma present value calculations of future tax liability under reasonable assumptions regarding expected holding periods until liquidation, the growth rate in value of the assets in the interim, and the tax consequences of liquidation, and with the virtual certainty that the tax will ultimately be recognized reflected in the discount rate?

[6] What rational buyer would subject itself to such exposure and pay hard dollars today against the chance of mitigating, for such a long period, the gain via an S election? This argument has nothing to do with fair market value or rational investment.

The arguments of the IRS Position are simple. Unfortunately, they do not follow the basic definition of fair market value (see below) and have incorrectly focused the attention of appraisers and the Tax Court on irrelevant issues.

The Business Appraisers' Position

The basic argument for considering the imbedded tax liability related to an imbedded gain in a C corporation flows from common sense: *If the tax cannot reasonably be avoided, it must be considered in valuation*. After all, the components of a fair market value transaction include a willing buyer and a willing seller, both of whom are fully (or at least, reasonably) informed of the facts surrounding the subject investment, neither of whom is under compulsion to engage in a transaction, and both of whom have the financial capacity to engage in a transaction. Based on these components, the hypothetical willing buyer and seller engage in a (hypothetical) transaction.[7]

Following the passage of TRA '86, analysts at many appraisal firms made calculations and judgments leading to the inevitable conclusion that if substantial imbedded gain existed in a C corporation asset holding company, it should be considered explicitly in the valuation of interests in that company. After all, how could a rational investor ignore the reality of imbedded capital gains? Unfortunately, appraisers have been, collectively, as guilty of failing to formalize their valuation logic as has the IRS (with some exceptions, noted below).

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[7] This is a paraphrasing and elaboration on the definition of fair market value in Rev. Rul 59-60, 1959-1 CB 237.

What has followed since 1986 has been a cat-and-mouse game over the issue. Many appraisers have routinely considered imbedded capital gains taxes as liabilities in the determination of net asset value of C corporation holding entities since 1986. Given the frequency of occurrence of the issue in practice, we can only assume that, in most situations, the question is either resolved or ignored prior to rising to the level of Tax Court litigation. Unfortunately, in the Tax Court cases in which the question *has* been raised, the common element is the paucity of economic evidence from appraisers that has been mentioned in the court's decisions.

The Valuation Literature

Very little has been written on the issue of imbedded gains. A recent search found only a limited treatment of the issue in the valuation literature. The various valuation texts are virtually silent with respect to hard positions on the issue.

Responding to TAM 9150001, John Gasiorowski wrote an article in *Business Valuation Review* in 1993, which concluded: Investors have access to alternatives. Under the economic principles of anticipation and substitution, investors will pay less to acquire an interest in a real estate holding company organized as a C corporation than for an equivalent interest in an identical entity organized differently. Because corporate level taxes affect strategic outcomes, the impact of corporate taxes must be considered in the valuation.[8]

In *Shannon Pratt's Business Valuation Update*, we find this brief position: In most (if not all) cases, I believe that the

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[8] Gasiorowski, "Is a Discount for Built-in Capital Gains Tax Justified?" | 2 Bus. Val. Rev. 35 (June 1993).

liability for trapped-in capital gains taxes *should* be reflected in the value of the stock or partnership that owns the assets. However, the IRS, the U.S. Tax Court and many family law courts have not, at least as yet, fully shared this view....Consensus is building among appraisers that the built-in capital gains tax should be recognized one way or another, either in the form of a balance sheet adjustment or some type of a discount.[9]

In a thoughtful 1996 article in *Estate Planning*, William Frazier advanced the position that the built-in capital gains taxes should be considered as a liability in the valuation of closely held corporations. Frazier concluded: Courts uniformly should abandon the ill-founded notion that the built-in corporate capital gains tax not be allowed as a reduction in the value of the equity of a closely held company when liquidation is only speculative. The premise for this policy has been undermined with the repeal of *General Utilities*. Observations from the marketplace, which should be the primary source of value determination, clearly show that the application of outdated legal precedents and the IRS viewpoint espoused in TAM 9150001 is out of step with economic reality, resulting in tax valuations that are unjustly burdensome. Failing to take into account capital gains taxes will result in the continuation of an ambiguous policy of determining value by a standard different from fair market value.[10]

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[9] Pratt, "Trapped-in capital gains affects real-world value." 2 Shannon Pratt's Business Valuation Update 33 (February 1996). Pratt was one of the experts in the *Davis* case, discussed below.

[10] Frazier, "How Corporate-Level Capital Gains Taxes Affect Fair Market," 23 Est. Plan. 198 (June 1996). Frazier is a partner of Alex W. Howard, another of the experts in *Davis*.

Steven Bolten noted that, at the first sign in early 1997 that the capital gains tax might be cut by up to half its then-current rate, the financial markets reacted by lowering the discount to net asset values for closed-end investment companies. Bolten concluded: This observed decline in the discount to net asset value for the closed end investment companies, concomitant with the likely enactment of a capital gains tax cut, surely is evidence that the financial markets are, indeed, incorporating the trapped-in capital gains tax liability in valuations.[11]

The bottom line is that the IRS has argued loudly and consistently that imbedded capital gains should be ignored in fair market value determinations. Appraisers, on the other hand, have argued, albeit less loudly and less consistently, that imbedded capital gains should be considered. The Tax Court, at least until the issuance of *Davis*,[12] has either sided with the IRS or avoided taking a clear stand on the issue.

Davis

Davis followed shortly on the heels of *Estate of Welch*,[13] which was issued in May of 1998. In *Welch*, the Tax Court's opinion followed the historical line of cases noted above, and disallowed consideration of the imbedded capital gains

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[11] Bolten, "Financial Market Valuations Include Trapped-In Capital Gains Liabilities," 16 Bus. Val. Rev. 23 (June 1997).

[12] 110 TC No. 35 (1998).

[13] TCM 1998-167.

liability in two closely held companies.[14] In *Davis,* however, the court specifically allowed consideration of the imbedded capital gains tax in a C corporation asset holding company.

Davis will be reviewed extensively in many forums. For our purposes, we can summarize the basic facts as follows:

- Artemus D. Davis made two gifts of 25 shares of A.D.D. Investment and Cattle Company (ADDI&C), representing 25.8% (each) of the 97 shares outstanding as of November 1992, a distinctly post-*General Utilities* doctrine valuation date. The gift tax return was supported by an appraisal prepared by Alex W. Howard of Howard Frazier Barker Elliott, Inc.

- ADDI&C owned a block of stock comprising approximately 1.3% of Winn-Dixie Stores, Inc., a large grocery chain whose shares trade on the New York Stock Exchange. The block had a market value of $70 million at the valuation date, and a cost basis of $338,000. Davis was a founder of Winn-Dixie, and ADDI&C was incorporated in 1947.

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[14] Interestingly, the taxpayer in *Welch* submitted valuation reports on the two companies prepared by Mercer Capital for another purpose entirely, and as of a different valuation date, without the knowledge of Mercer Capital. A discussion of *Welch* can be found in Mercer Capital's newly initiated *E-Law Newsletter*, Volume 1, Issue 1, "How Easy it is for Appraisers to Misinterpret a Case!" For more information, contact Mercer Capital at 1-800-769-0967 or at www.biz-val.com.

- ADDI&C had a net asset value of $80.1 million at the valuation date. The total trapped-in capital gain in the company was $70.9 million, of which $69.7 million resulted from the Winn-Dixie block of stock. The imbedded capital gains *liability* totaled $26.7 million (at the stipulated applicable rate of 37.63%), or about one third of the net asset value.

- In addition to the appraisal prepared by Howard, which was filed with the gift tax return, the taxpayer obtained a second appraisal prepared by Shannon P. Pratt of Willamette Management Associates. The IRS obtained an appraisal from John A. Thomson of Klaris, Thomson & Schroeder, Inc. All three appraisers are Accredited Senior Appraisers, having earned the ASA designation from the American Society of Appraisers. (Pratt holds the FASA designation, Fellow of the American Society of Appraisers.) All three appraisers prepared valuation reports and rebuttal reports that were reviewed by the court.

While *Davis* will always be remembered as an *imbedded capital gains* case, there were actually four distinct valuation issues dealt with by the appraisers and the court, each of which had considerable economic impact. Unlike many other Tax Court cases, and particularly those dealing with imbedded gains, the court had credible valuation evidence from three qualified appraisers on each point. Without editorializing, the issues are summarized below and in Exhibit 1, on page xx.

SEE FOLD OUT EXHIBIT

Exhibit 1

***Davis* Decision Analysis**

EXHIBIT 1
***Davis* Decision Analysis**

* *Adjusted for appropriate sequencing of discounts*

		For Taxpayer/Petitioner			
		Alex Howard		Shannon Pratt	
	Discounts	$'s	Discounts	$'s
1 Net Asset Value per Court		$80,140,269		$80,140,269
Fair Market Value of Winn-Dixie Stock	$70,043,204		$70,043,204	
2 Blockage/Rule 144 Discount	-4.9%	($3,432,117)	-10.0%	($7,004,320)
3 Adjusted Net Asset Value		$76,708,152		$73,135,949
Imbedded Capital Gains	$70,918,455		$70,918,455	
4 Computed Imbedded Gain Tax *	35.8%	($25,395,109)	0.0%	$0
5 Net Asset Value of ADDJ&C		$51,313,043		$73,135,949
6 Minority Discount	15.0%	($7,696,956)	20.0%	($14,627,190)
7 Marketable Minority Interest Value		$43,616,087		$58,508,759
8 Marketability Discount	35.0%	($15,265,630)	35.0%	($20,478,066)
9 Subtotal *		$28,350,456		$38,030,693
10 "Cap Gains" Marketability Discount (to Line 7)	0.0%	$0	15.0%	-$8,776,314
11 Nonmarketable Minority Interest Value *	35.0%	$28,350,456	50.0%	$29,254,379
12 Value of Each 25-Share Block	25.77%	$7,306,825		$7,539,796
13 Fair Market Value per Share *	97	$292.273		$301.592
The "Delta"				
14 Total dollar value of valuation discount		$51,789,813		$50,885,890
15 Overall Discounts as a % of Stipulated Net Asset Value		64.6%		63.5%
16 Conclusion as a % of Net Asset Value		35.4%		36.5%

[ ] Indicates total "marketability discount" including consideration of imbedded capital gains

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For IRS/Respondent						
John Thomson			The Court		The Court (Adjusted)*	
Discounts		$'s	Discounts	$'s	Discounts	$'s
		$80,140,269		$80,140,269		$80,140,269
$70,043,204			$70,043,204		$70,043,204	
0.0%		$0	0.0%	$0	0.0%	$0
		$80,140,269		$80,140,269		$80,140,269
$70,918,455			$70,918,455		$70,918,455	
0.0%		$0	0.0%	$0	12.7%	($9,000,000)
		$80,140,269		$80,140,269		$71,140,269
12.0%		($9,616,832)	15.0%	($12,021,040)	16.9%	($12,021,040)
		$70,523,437		$68,119,229		$59,119,229
23.0%		($16,220,390)	27.9%	($19,000,000)	32.1%	($19,000,000)
		$54,303,046		$49,119,229		$40,119,229
15.0%		-$10,578,516	13.2%	-$9,000,000	0.0%	$0
38.0%		$43,724,531	41.1%	$40,119,229	32.1%	$40,119,229
		$11,269,220		$10,340,017		$10,340,017
		$450,768		$413,600		$413,600
		$36,415,738		$40,021,040		$40,021,040
		45.4%		49.9%		49.9%
		54.6%		50.1%		50.1%

Restricted stock issue.

The Winn-Dixie shares were restricted under Rule 144 of the Securities and Exchange Act of 1934. Restrictions on the marketability of the block based on its size and trading restrictions needed to be considered. The taxpayer's appraisers (Howard and Pratt) recommended discounts of 4.9% and 10%. Howard's discount was based on the use of the Black-Scholes option pricing model, and Pratt's was based on unquantified judgment. Thomson said that no restricted stock or blockage discount was appropriate because of the rising trend in Winn-Dixie's shares. Based on its review of the record and the testimony of the experts, the court did not allow any restricted stock or blockage discount for the Winn-Dixie shares.

Minority interest discount.

There was little discussion in the case of the minority interest discount issue. The recommendations of the appraisers were 15% (Howard), 20% (Pratt), and 12% (Thomson). The court's concluded minority interest discount was 15%, a fact determined by inference from the opinion.

Marketability discount.

All three appraisers recommended marketability discounts to the court. Two of the appraisers, Pratt and Thomson, incorporated their consideration of the next issue, the imbedded capital gains question, into their overall marketability discount analysis. Their reasoning was that such a large trapped-in liability would certainly impede the marketability of the subject shares. Excluding the specific consideration of imbedded capital gains, Howard and Pratt relied on various restricted stock studies and pre-IPO studies,

as well as their analyses of the various factors of the case. Thomson relied only on restricted stock studies and his analysis.[15] The marketability discounts suggested by the experts were 35% (by Howard and Pratt)and 23% (by Thomson). The court concluded that the appropriate marketability discount was $19 million, which translated into a marketability discount of 27.9%.

The imbedded capital gains issue.

The court was presented with three different views of the treatment of imbedded capital gains. Howard took the position that the tax on the imbedded gain represented a present, economic liability. He therefore tax-effected the gain at estimated statutory rates and reduced net asset value by the full amount of the imbedded liability.[16] The IRS broke ranks with its appraiser and declared to the court that there should be no consideration of imbedded gains in the determination of fair market value as a matter of law. Pratt (for the taxpayer) and Thomson (for the IRS) advocated a middle-ground position. As noted earlier, they considered that the imbedded tax liability would be an additional impediment to the marketability of the subject interests. Both suggested that the "extra" factor should add 15% to their otherwise determined

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[15] The restricted stock studies and pre-IPO studies cited by the experts in *Davis* are summarized in a recent book. See Mercer, *Quantifying Marketability Discounts: Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests* (Peabody Publishing, LP. 1997). Chapters 2, 3, and 12 deal with these studies at length.

[16] The reasonableness of his position is affirmed below. This is the Business Appraisers' Position stated at the outset of this column.

marketability discounts, resulting in partial considerations of the imbedded tax liability.

The court was unconvinced by the IRS argument for no consideration of imbedded gains liabilities as a matter of law. Howard was no less convincing to the court with his argument that a full consideration of the imbedded gain should be deducted from net asset value. The court explained: Petitioner adopts the view of petitioner's expert Mr. Howard and argues that the full amount of such tax should reduce ADDI&C's net asset value in making that determination. On the record before us, we reject petitioner's position and Mr. Howard's opinion. On that record, we find that *where no liquidation of ADDI&C or sale of its assets was planned or contemplated on the valuation date*, the full amount of ADDI&C's built-in capital gains tax may not be taken as a discount or adjustment in determining the fair market value on that date ... *even though we have found that as of that date it was unlikely that ADDI&C could have avoided all of ADDI&C's built-in capital gains-tax, and the record does not show that there was any other way as of that date by which ADDI&C could have avoided all of such tax.* (Emphasis added, citations omitted.)

The court apparently agreed with the manner in which Thomson and Pratt considered a partial treatment of the imbedded gain as an incremental impediment to marketability. Both added 15% to their marketability discounts, which provided a range of dollar liabilities of $8.8 million (Pratt) to $10.6 million (Thomson).[17] Within this range, the court held

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[17] It is almost impossible not to editorialize. Both Pratt and Thomson agreed that the imbedded capital gain should be considered in the valuation of post-1986 C corporations. Thomson, to his credit, stuck to his valuation guns in the face of a client that

that the appropriate consideration of the imbedded gains tax liability was $9 million. Given that the total imbedded gain liability was $26.7 million, the court allowed a deduction to net asset value of some 34% of the imbedded liability. The effective tax rate used by the court on the imbedded gain was therefore 12.7% (i.e., $9 million divided by the $70.9 million taxable gain inside ADDI&C).

Based on the record in *Davis*, the court rejected both positions outlined at the beginning of this column, the full consideration of imbedded capital gains liabilities advocated by many business appraisers (the Business Appraisers' Position), and the absence of consideration advocated by the IRS (the IRS Position). It is not clear from the case as to how Pratt and Thomson arrived at their partial considerations of the imbedded gain in ADDI&C. It is clear, however, that the court was amenable to the consideration of economic arguments that attempted to simulate the thinking of hypothetical buyers of minority interests in ADDI&C common stock.

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undoubtedly pressured him not to consider any liability for imbedded gains taxes. He gave partial treatment of the liability in the guise of a larger marketability discount. Given that the Tax Court had been so negative on opinions like that of Howard in the past, Pratt undoubtedly believed that a consideration as an incremental marketability discount was a way to introduce a legitimate valuation adjustment that the court has disfavored as part of one that the court has favored. Neither Pratt nor Thomson, however, provided any economic rationale for their selected 15% increases to their marketability discounts. As a result, there is no basis for using this case to justify a treatment of imbedded gains tax liabilities in any other matter.

Davis stands, in our opinion, as a mandate by the Tax Court to appraisers to articulate their economic and valuation rationales for considering the impact of imbedded gains on hypothetical negotiations between hypothetical willing buyers and sellers.

Eisenberg

As this article was being finalized, the Second Circuit released its decision regarding the appeal of the October 1997 *Eisenberg* decision of the Tax Court.[18] Without going into details of the earlier case, we can summarize that Irene Eisenberg owned all the outstanding common stock of a C corporation that held a building in Brooklyn. After stipulations of the fair market values of the building on three gift dates and a 25% minority interest discount, the sole issue for determination by the Tax Court was whether to consider a valuation adjustment for the imbedded capital gains tax liability inside the corporation. The taxpayer argued for full consideration of the imbedded liability, and the IRS argued for no consideration. The Tax Court held for no consideration, citing the cases outlined above and the rationale regarding the speculative nature of any liquidation of the company.

The Second Circuit reviewed background cases on the imbedded tax issue, as well as a brief history of the *General Utilities* doctrine and of its repeal in 1986. Brief quotes from the appellate decision trace the court's conclusion that rational purchasers of shares of post-1986 C corporations would consider the impact of imbedded tax liabilities on the price they are willing to pay for interests in such corporations.

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[18] Note 4, *supra*.

We quoted the court's position earlier, disfavoring the consistent citing of pre-1986 valuation date cases by the IRS to support post-1986 valuation economics. Regarding the recurring theme that imbedded capital gains should not be considered because there is no plan of liquidation in place, and the resulting implications for hypothetical willing buyers, the court stated: Fair market value is based on a hypothetical buyer and a willing seller, and in applying this willing buyer-willing seller rule, *the potential transaction is to be analyzed from the viewpoint of a hypothetical buyer whose only goal is to maximize his advantage*...[C]ourts may not permit the positing of transactions which are unlikely and plainly contrary to the economic interest of a hypothetical buyer...' (Emphasis added.)[19]

Elaborating on this position, the court said: *Our concern in this case is not whether or when the donees will sell, distribute or liquidate the property at issue, but what a hypothetical buyer would take into account in computing fair market value of the stock.* We believe it is common business practice and not mere speculation to conclude a hypothetical willing buyer, having reasonable knowledge of the relevant facts, would take some account of the tax consequences of contingent built-in capital gains on the sole asset of the Corporation at issue in making a sound valuation of the property....The issue is not what a hypothetical willing buyer plans to do with the property, but what considerations affect the fair market value of the property he considers buying...*We believe that an adjustment for potential capital gains tax liabilities should be taken into account in valuing the stock at issue in the closely held C corporation even though no*

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[19] Citing Estate of Curry, 706 F.2d 1424, 51 AFTR2d 83-1232 (1983).

liquidation or sale of the Corporation or its assets was planned at the time of the gift of the stock. (Emphasis added).[20]

If *Davis* stands as a mandate to business appraisers to become specific in their development of valuation adjustments relating to the imbedded capital gains issue, *Eisenberg* is our clarion call.

Proof of the Business Appraisers' Position

Buyers of appreciating properties, broadly defined-whether stocks, land, investment properties, or other assets--generally have the option of acquiring desired investments in the normal markets for the properties. Negotiations occur between buyers and sellers for the properties and transactions are effected.

Here we are discussing situations in which appreciating properties are, for whatever historical reasons, residing inside C corporation holding companies. Since 1986, appreciation inside such corporations is subject to income taxation. Sellers desiring to obtain the market value of appreciated properties inside C corporation have two basic options:

1. Liquidate the assets inside the corporation, pay any corporate tax on the appreciation of the assets on their sale, and then either make substantial distributions of

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[20] The court did in a footnote, indicate that a full deduction of the tax liability from net asset value might not be considered, but concluded in the next footnote: "In any event, all of these circumstances should be determined as a matter of valuation for tax purposes." *Id.*, at n. 16.

the net assets or engage in a liquidation of the corporation.

2. From the universe of potential buyers of the assets inside the corporation, find a buyer who will purchase the C corporation's stock as a vehicle to access the assets–a buyer who either has reasons to own the assets inside a C corporation, or who will liquidate the corporation to gain access.

When analyzing the impact of imbedded capital gains in C corporation holding companies, one must examine the impact in the context of the opportunities available to the selling shareholder(s) of those entities. One must also consider the realistic option that potential buyers of the stock of those entities must be assumed to have–that of acquiring similar assets directly, without incurring the problems and issues involved with imbedded capital gains inside a C corporation.

SEE FOLD OUT EXHIBIT

Exhibit 2

Analysis of Alternative Purchase Arrangements for Acquiring Appreciating Property in a C Corporation

EXHIBIT 2
Analysis of Alternative Purchase Arrangements for Acquiring Appreciating Property in a C Corporation

Property Growing in Value @	6.0%
Corporate Marginal Tax Rate	40.0%
Personal Capital Gains Rate	20.0%

		I	II		III (The IRS Position)		IV		V	
		Buyer Acquires Property Outright at Fair Market Value	*Buyer Buys C Corp Stock with Property Basis Inside Corp Equal to Its Fair Market Value*		*Buyer Buys C Corp Stock with Large Imbedded Gain/Liability and Pays Price with no Reduction for Liability*		*Buyer Buys C Corp Stock with Mid-Range Imbedded Gain and Reduces Price by Imbedded Liability $ for $*		*Buyer Buys C Corp Stock with Large Imbedded Gain and Reduces Price by Imbedded Liability $ for $*	
(000's)		Buyer and Seller	Buyer	Assume Seller Liquidates	Buyer	Assume Seller Liquidates	Buyer	Assume Seller Liquidates	Buyer	Assume Seller Liquidates
Fair Market Value of Property	1	$1,000	$1,000		$1,000		$1,000		$1,000	
Sell Property at Fair Market Value	2			$1,000		$1,000		$1,000		$1,000
Relative to C Corporation										
Inside Basis of Property	3	na	$1,000		$1		$500		$1	
Imbedded Gain	4	na	$0		$999		$500		$999	
Imbedded Gains Tax	5	na	$0	$0	($399.60)	($399.60)	($200)	($200)	($399.60)	($399.60)
Buyer Pays to Seller	6	$1,000	$1,000	$1,000	$1,000	$1,000	$800	$800	$600.40	$600.40
Buyer Acquires	7	Asset	Stock		Stock	Asset	Stock	Asset	Stock	Asset
Seller Basis in Asset or Stock	8	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown
Seller Net Proceeds	9	$1,000	$1,000	$1,000	$1,000	$600.40	$800	$800	$600.40	$600.40
Seller Capital Gains Taxes	10	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown	Unknown
Buyer 1-Year Return	11	4.8%	2.9%		-29.1%		3.6%		4.8%	
Buyer 5-Year Return	13	4.9%	3.1%		-3.4%		3.8%		4.9%	
Buyer 30-Year Return	14	5.4%	4.0%		3.7%		4.6%		5.4%	
Buyer/Seller Parity?	15	I–Yes	II–No		III–No		IV–No		V–Yes	
Buyer/Seller Relative Positions →		*Each receives or pays fair market value for Property.*	*Buyer achieves lower returns than if acquires Property directly. There is a penalty for acquiring Property in C Corp.*		*Buyer loses $'s if liquidates early and achieves lower returns than if purchases property directly.*		*The penalty of acquiring property in a C Corp found in Alternative II surfaces again with a mid-range imbedded gain assumption.*		*Seller is indifferent to sale of stock or liquidation. Buyer has same returns as if purchases Property directly (with lower $ investment).*	
Buyer/Seller Negotiating Points →			*Buyer may have to pay FMV for Property with no discount because seller can liquidate and achieve this result.*		*Payment of a price for stock not considering the imbedded gain is tantamount to a gift from buyer to seller.*		*Buyer may have to pay FMV for Property with no discount because seller can liquidate and achieve this result.*		*Only under Alternative V is the buyer indifferent to acquiring the Property outright vs by an acquisition of C Corp. stock.*	
Overall Conclusion of Analysis →			*Overall Conclusion. A rational willing buyer will pay no more than a price for shares of a C corporation asset holding company that recognizes 100% of the imbedded gain tax liability in that C corporation. A rational seller will sell for no less than this amount because of the ability to liquidate and achieve this result. Rational negotiations between hypothetical willing buyers and sellers should lead to a full recognition of imbedded capital gains tax liabilities in the determination of the price to be paid for the C corporation's share (absent any compulsion on the part of the buyer or the seller).*							

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In Exhibit 2, on page xx, we have attempted to analyze the impact of imbedded capital gains in C corporation holding companies from the vantage point of hypothetical willing buyers and sellers. Through this analysis, we are seeking to reach conclusions regarding whether or how the issue of such imbedded gains, and their associated tax liabilities, would reasonably influence the negotiating positions of buyers and sellers of the stock.

We prepared a series of spreadsheet models that attempt to simulate a series of transactions involving both buyers and sellers of C corporation holding companies containing appreciating property, in the context of current tax law. Summary results of the modeling are found in Exhibit 2. The property involved has an assumed fair market value of $1 million, the corporate tax rate on imbedded gains is assumed to be 40%, and the personal marginal (capital gains) tax rate is assumed to be 20%. In the example, the asset is assumed to be growing in value at a rate of 6% per year, and pays no dividends.[21] A further assumption is that there are no costs involved in liquidating the C corporations other than the necessity to pay imbedded capital gains taxes.[22]

Essentially, Exhibit 2 analyzes five alternative purchase options available to a buyer of appreciating assets. The alternatives shown include:

1. The buyer acquires the property outright in the normal market for such property at its market value.

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[21] The results of the modeling are generally not sensitive to either the tax rates assumed or to the growth rate in value of the property.

[22] This analysis could easily be adjusted for estimated costs of liquidation.

2. The buyer acquires C corporation stock when the basis of the property inside the corporation is equal to the property's fair market value in its normal market.

3. The buyer acquires C corporation stock with a large imbedded gain and imbedded tax liability (i.e., with virtually a zero basis inside the corporation) and pays the seller a price for the shares that reflects no reduction for the imbedded tax liability.

4. The buyer acquires C corporation stock with the basis of the property inside the corporation equal to 50% of the fair market value of the property (called a mid-range imbedded gain in Exhibit 2). In this case, the buyer reduces the price paid for the stock by the imbedded tax liability on a dollar-for-dollar basis.

5. The buyer acquires C corporation stock with a large imbedded gain and imbedded tax liability (as in Alternative 3), and the price paid for the stock is again reduced by the full amount of the imbedded tax liability.

Analysis of Exhibit 2 leads to the conclusion that rational buyers of C corporation holding companies with appreciated assets will negotiate to reduce the purchase price paid for the stock by the full amount of any imbedded capital gains tax liabilities. The rationale for this conclusion can be summarized by the following points:

- The buyer always has the presumed opportunity to acquire similar property in the open market. The rate of return from an investment in the property from this alternative should reasonably be used to evaluate options involving the acquisition of the

same or similar property through the purchase of C corporation stock.

- Under Alternative 2, where there is no present imbedded gain, there is an argument that the buyer should discount the price for the stock because the anticipated *future* capital gains and capital gains taxes at the corporate level will lower the expected holding period return for any reasonable holding period. The seller of the corporation, however, has the capability of liquidating the corporation and therefore will not likely negotiate a reduction for the future liabilities of the buyer. Further, the buyer, once having purchased the stock, has the option of liquidating the corporation to gain direct access to the asset without incurring future capital gains associated with C corporation status.[23]

- Alternative 3 is the analytical equivalent of the IRS Position (pre-*Davis* and pre-*Eisenberg*) with respect to imbedded capital gains. In this alternative, there is a large imbedded capital gain in the corporation (much like the gain in ADDI&C in *Davis* discussed above). By ignoring the imbedded capital gain and imbedded tax liability in Alternative 3, the buyer is placed at risk of loss of substantial principal if there is a necessary liquidation in the early years, or an unanticipated

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[23] In this example, it might be useful to examine the specific costs of liquidation. This is also a situation in which consideration of imbedded gains in operating companies with significant non-operating assets could depart from this argument. If it is not feasible to liquidate the corporation, a buyer might negotiate strongly for a further adjustment for future capital gains liabilities.

liquidation of the underlying property. For example, assume the property in Alternative 3 is Winn-Dixie stock. Assume further that the buyer pays $1 million for the stock, making no adjustment for the $400,000 imbedded tax liability in the C corporation. Finally, assume that the day after the closing of the transaction, Safeway agrees to purchase 100% of Winn-Dixie's stock for cash. The buyer has just turned a $1 million investment into $600,000, and would recognize a $400,000 loss. The economic effect of Alternative 3 is that the buyer has made a *gift* of sorts, the amount of the imbedded tax liability ($400,000), to the seller. This gift can be recognized in an early loss on liquidation or in the form of a permanently impaired rate of return in relationship to Alternative 1, the outright asset purchase alternative. Rational buyers are not in the business of making gifts to sellers of properties.[24]

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[24] To carry this analysis a bit further, adoption of the IRS Position regarding the nonrecognition of imbedded capital gains tax liabilities is tantamount to asking a taxpayer to make a gift, in the form of higher gift or estate taxes today, to the U.S. Treasury. A rational taxpayer is just as unlikely to desire to make such a gift to the Treasury as a rational buyer is to making the gift to a seller facing the imbedded obligation in a C corporation. This is particularly burdensome when the taxpayer will ultimately have to deal with imbedded capital gains tax in the corporation. In effect, the IRS Position would require the taxpayer to pay an additional tax. While that might be good for revenues for the Treasury, the IRS Position has nothing to do with the concept of the fair market value of C corporation stocks.

- In Alternative 4, with a mid-range imbedded gain of $500,000, the buyer of the C corporation's stock encounters a permanent impairment of return in relationship to Alternative 1, even though the stock's purchase price is lowered by the full amount of the imbedded tax liability. As in Alternative 2,there is an argument for the buyer to negotiate a further discount to account for capital gains on future appreciation; however, as in that alternative, the buyer has remedies, and the seller has the alternative of liquidating the corporation to avoid additional discounting.

- Only in Alternative 5, in which the corporation has a virtually zero basis in the property, is the buyer indifferent, from a rate of return perspective, to the outright purchase alternative of Alternative 1. In this case, the buyer reduces the stock's purchase price by the full amount of the imbedded tax liability, and the discount from fair market value is sufficient to offset the combined impact of future corporate and personal taxes. As is visually apparent, the compound returns available from Alternative 1, the outright purchase of the property are identical with those from Alternative 5.

The end result of this analysis is that there is not a single alternative in which rational buyers (i.e., hypothetical willing buyers) of appreciated properties in C corporations can reasonably be expected to negotiate for anything less than a full recognition of any imbedded tax liability associated with the properties in the purchase price of the shares of those corporations. Rational sellers (i.e., hypothetical willing sellers) cannot reasonably expect to negotiate a more

favorable treatment, because any nonrecognition of imbedded tax liabilities by a buyer translates directly into an avoidable cost or into lower expected returns than are otherwise available. Valuation and negotiating symmetry call for a full recognition of imbedded tax liabilities by both buyers and sellers.

Conclusions

Our analysis leads to this series of conclusions:

- Nothing in the analysis supports any concept that the speculative nature of an expected holding period should call for a "sharing" of the imbedded tax liability between sellers of C corporations and buyer of those corporations.

- Nothing in the analysis suggests that the lack of an imminent plan for the liquidation of a C corporation with imbedded gains is any reason not to consider the existence of imbedded tax liabilities directly in the purchase price of C corporation stock today.

- In the context of *Davis*, Howard's treatment of the imbedded tax liability of ADDI&C as a present liability in his appraisal is the most appropriate treatment of such imbedded tax liabilities. We have validated the Business Appraisers' Position.

- The partial treatment of the imbedded liability by Pratt and Thomson, while a step in the right direction, falls considerably short of dealing with the true economic impact of the liability from the

viewpoint of the hypothetical buyer of ADDI &C shares.

- This entire analysis has dealt with buyers of 100% of the stock of C corporation asset holding companies. If the analysis suggests that rational purchasers of *control* of the entities would require that the price of the stock reflect a reduction for the dollar amount of imbedded tax liabilities, it is even more supportive of such consideration for hypothetical buyers of minority interests.

The Tax Court (in *Davis*) and the Second Circuit (in *Eisenberg*) have recognized the economic reality of imbedded capital gains tax liabilities and that such liabilities are appropriately considered in the determination of the fair market value of C corporation asset holding companies. However, appraisers who attempt to argue for a partial discount by citing *Davis* stand a good chance of losing their arguments based on differing facts or circumstances, or on the lack of economic justification for their positions. Appraisers are responsible for providing valuation and economic evidence to the courts. The door is clearly open for the admission of such evidence regarding imbedded capital gains tax liabilities in C corporation asset holding companies.